No. 14837

United States
COURT OF APPEALS
for the Ninth Circuit

THE FIRST NATIONAL BANK OF PORTLAND, a National Banking Association,

Appellant,

vs.

FRANK A. DUDLEY, Trustee in Bankruptcy of the Estate of Northwest Variety Wholesale, Inc.,

Appellee.

REPLY BRIEF OF APPELLANT

Appeal from the United States District Court for the District of Oregon.

PENDERGRASS, SPACKMAN & BULLIVANT,
V. V. PENDERGRASS,
R. R. BULLIVANT,
WALTER H. PENDERGRASS,
Pacific Building,
Portland, Oregon,
Attorneys for Appellant, The First National Bank of Portland.

EDWARD A. BOYRIE,
Pittock Block,
Portland, Oregon,
Attorney for Appellee.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE. 11-55

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This Reply Brief is submitted to answer certain of the contentions and arguments and clarify some of the statements contained in the Brief of Appellee. For convenient reference, the arguments of appellee will be considered in the order of their presentation in his brief.

Before discussing the details of appellee's brief, we wish to emphasize its significant failure to show that the Loble case, upon which virtually his sole reliance is placed, is in point. It was based on a state of facts in

which the banker asserting set-off was a party to an agreement with the bankrupt and certain of the bankrupt's creditors which provided for the making of deposits in an existing account, derived from the sale of specific property, and for the use of these deposits exclusively for a group of creditors other than the banker. There was, in essence, a special deposit or series of deposits earmarked for a special purpose, and the attempted set-off violated the express conditions agreed to by the bank. Here, to the contrary, there is no pretense of any agreement for the making of deposits in the account or for the use or application of the deposits. In other words, there was no arrangement for a special deposit.

We said in our opening brief, and here repeat, that the right of set-off exists, under the cases, unless there is a relationship involving a type of special deposit, trust fund, estoppel or waiver. Since the Loble case involved what was really a special deposit, it is wide of the mark.

APPELLEE'S PROPOSITION I

Appellee admits the general rule that a creditor has the right to set off a debt owing by it to the Bankrupt against a debt owing by the Bankrupt to it and that, if the parties do not effect the set-off prior to bankruptcy, it is the duty of the Trustee to do so after bankruptcy. But Appellee asserts that this rule is subject to the modification that it is permissive, rather than mandatory, and should be construed so as to promote equality and justice in accordance with principles of equity.

In support of his contention that set-off is an equitable matter Appellee cites three cases. The first is the case of *Union Bank and Trust Company of Helena, Montana v. Loble* (9th Cir.) 1927, 20 F. 2d 124. It will be discussed at a later portion of this brief. The second is the case of *Cumberland Glass Manufacturing Company v. Charles DeWitt,* 237 U.S. 447, 59 Law Ed 1042, quoted on page 7 of Appellant's brief, and was an action by DeWitt against the Glass Company for damages allegedly resulting from a conspiracy in which the Glass Company participated. Judgment was rendered in favor of DeWitt and the Glass Company appealed. The only defense before the Supreme Court for consideration was one of res judicata. The language of the court quoted in Appellee's brief is appropriate in its setting, but it cannot be removed from it and certainly has no application to the facts before this Court in the present case.

The case of *Prudential Insurance Company of America. v. Nelson* (CCA 6th Circuit),101 F. 2d 441, cited on page 8 of Appellee's brief, concerned a question of whether or not a right of set-off existed at all. The court held that, under the peculiar circumstances of the case, the credit which the insurance company was attempting to set off had not arisen until after the filing of the petition in bankruptcy. Therefore, since there were no mutual debts and credits existing at the time of the filing of the petition, there was no set-off available.

We submit that neither of these cases supports the proposition for which it was cited. The cases referred to in Proposition I of Appellant's brief are square in their

holding that Section 68a of the Bankruptcy Act is a codification of the common law right of set-off and that it is a right to which the creditor is basically entitled, unless he be shown to have in some way renounced it. It is not, as it seems to us the Appellee contends, a right to which the creditor must show he is entitled. The burden is on him who opposes the exercise of the right to show why it should be denied, not on him who would exercise it to show why he should be allowed it.

On pages 9 and 10 of his brief, Appellee first falls into the error of regarding the Loble case and this case as being not distinguishable. Appellee states that:

> "All that is held in the case at bar, as in the Loble case heretobefore decided by this Court, is that a bank will be precluded from asserting a set-off where it enters into an arrangement with the depositor and his other creditors involving an extension of time to the depositor to pay his debts, and use of the assets of the depositor for the making of payments to creditors, including the bank, on a pro-rata basis."

We submit that this statement is incorrect. In this case there was no agreement or arrangement of any kind, express or implied, that the assets of the bankrupt depositor should be used for making payments to creditors on a pro rata basis. Indeed, there is no evidence or finding that there was any communication at all between the Bank and other creditors or that the Bank had anything whatsoever to do with the extension of time which was obtained from other creditors, or any supervision or control of any kind over the Bankrupt's operation.

If a right of set-off is denied in this instance it must be upon the basis that by granting an extension of time for the purpose of enabling the debtor to attempt to work out of its financial difficulty, the Bank is thereafter forever prohibited or estopped from asserting the right. This is not and should not be the law.

During the course of his brief the Appellee makes continued referrence to a "Plan" or "Proposition" without ever defining his terms, but creating the inference that a formal detailed proposal involving liquidation of inventory and, perhaps, dissolution, was presented to and accepted by the Bank. Such is not the fact.

The Bankrupt did advise the Bank that it had a heavy inventory that could be disposed of to best advantage over a full year of normal business operation. But the Bankrupt never did present a "plan of liquidation" to the Bank, nor did the Bank ever inject itself into the Bankrupt's operations nor did it receive or request any report or statement from the Bankrupt. At the Bankrupt's request, the Bank agreed that it would not pursue the immediate collection of the defaulted obligation provided, and only provided, the Bankrupt made payments of not less than ten per cent per month on that obligation. That was the whole agreement, and the manner in which that sum was to be raised by the Bankrupt and whether or not any other creditor was a party to a similar agreement was no concern of the Bank. (Transcript of Record, p. 18, par. 4 and 5.)

Appellee has stated several places in his brief that there is no evidence in the record as to the balance in

the Bankrupt's account at the time that the Bankrupt presented its proposal to Appellant Bank. Appellant's Exhibits 5 and 6 include a complete statement of the running balances in the Bankrupt's account for the period from November 20, 1952, until the account was closed in July of 1953, and a complete record of the high and low monthly balances in the account for the period from January 5, 1951, through June, 1953. The conference which resulted in the proposal made by the Bankrupt occurred some time in early December of 1952 (Transcript of Record, p. 41, 66). The high and low balances in the Bankrupt's account during the month of December, 1952, are consequently quite relevant in showing the amount which was available for offset by Appellant when the request for extension was originally made.

It is obvious from an examination of the above mentioned exhibit that if Appellant had offset the substantially larger deposit that was in the account of the Bankrupt at the time of the original request for an extension of time and had participated with other creditors in the net proceeds derived from the sale of the remaining assets of the Bankrupt, it would have netted a very substantial sum in excess of that which it has obtained by deferring the exercise of its right until after bankruptcy, at which time there was a much smaller amount in the account against which the debt of the Bankrupt could be charged.

APPELLEE'S PROPOSITION II

This Proposition is an elaboration of the thesis advanced in the first Proposition that "the primary question . . . is whether, under the facts of the particular case, it was equitable and in the furtherance of the principles of equity and justice that the set-off should be allowed". Appellee appears to admit the elements of estoppel or waiver are not present, but contends that, "in the furtherance of principles of equity and justice", the Bank should be denied its right of set-off.

In support of his contention, Appellee quotes from American Jurisprudence, Section 35, on the subject of Estoppel, which distinguishes between equitable estoppel and technical estoppel, but Appellee does not then explain in what manner or on what theory either principle is applicable to the facts before this Court.

And Appellee then quotes from 31 C.J.S., Section 61, which defines waiver as "the intentional relinquishment of a known right, or such conduct as warrants an inference of the relinquishment of such right". But again, where is the evidence that this known right of set-off was intentionally relinquished at any time or where is the conduct that warrants the inference of any relinquishment or intention to relinquish such right? The record will show that the testimony is exactly to the contrary—unless this Court is to hold that the mere fact that Appellant voluntarily extended the time of payment of a matured obligation and, in order to give the Bankrupt an opportunity to work out its difficulties, did not exercise its right of set-off to a much larger sum of

money than was available at the time of bankruptcy, constitutes such an inference.

On page 15 of his brief Appellee states that "the Bank elected not to exercise its right of set-off against the existing account and to go along with the Plan, and so advised the Bankrupt". Again we state that there never was any such election unless this Court is to hold that the granting of the extension of time without exercising the right of set-off which was then available constitutes an election. And if it does, then it necessarily follows that that any creditor having the right of set-off available to him is precluded from cooperating with a debtor, or even granting an extension of time, without at the same time, intentionally or unintentionally, waiving a valuable right. Such a construction of the statute was never intended and cannot possibly be justified.

Appellee made the following statement at page 12 of his brief:

> "As will be seen, the Courts in disallowing the right of set-off in certain cases, have not been concerned primarily with whether or not a waiver or an estoppel or a trust fund in the technical sense existed in the particular case. To be sure, in some cases estoppel or waiver or a trust fund in the strictly technical sense has existed. The primary question however, has always been; whether, under the facts of the particular case, it was equitable and in furtherance of the principles of equity and justice that the set-off should be allowed."

Appellee has cited cases in support of his statement that the courts have not been concerned whether waiver, estoppel or trust fund "in the technical sense" was present. We suggest they do not support that proposition.

In re Mauch Chunk Brewing Company, 131 F. 2d 48, cited at page 14 of Appellee's brief, concerned an actual waiver. The bank, at the request of the trustee, turned over to the trustee the balance in the account of the brewing company. The trustee opened an account in his own name and deposited in it the funds withdrawn and also other funds. The bank then sought to set off the balance in the trustee's account against an indebtedness owing to it by the brewing company. The court held that the bank, having surrendered the account and thus extinguishing the claim of the brewing company against it, could not revive the claim and assert it against the trustee or offset it against the funds in the trustee's account. This, of course, is very different from what happened in the instant case.

In the case of *Wagner v. Citizen's Bank & Trust Co.*, 122 Tenn. 164, 122 S.W. 245, cited and discussed at pages 17, 18 and 19 of Appellee's brief, the court stated that ". . . it was understood by the defendant bank that this fund was deposited with it as a *special fund* for pro rata distribution among all the creditors of the Wilcox Furniture Company". (Emphasis added) It will be noted that the denial of that bank's right of set-off is based upon the acknowledged purpose of the deposit as a "special fund" and that bank's "agreement with other creditors" concerning the manner in which and the purpose for which the funds would be used.

Lyman v. Belfast National Bank (98 Me. 448, 57 At. 799), discussed in Appellee's brief at page 19, involved a situation where the sum which the bank attempted to set off had been deposited with it for *safekeeping*, and

the bank knew that that was the purpose of the deposit. The court rightly held that the bank could not accept the deposit for safekeeping and then repudiate that agreement by exercising the right of set-off. This is a clear case of estoppel, and the elements of representation, reliance and prejudice are all present. None of these elements is present in the case before this Court.

In another case cited at page 20 of Appellee's brief, *In re Davis,* 119 F. 950, the bankrupt deposited the proceeds of the sale of certain goods with the bank, *taking a receipt which recited on its face* that the money was to be paid to the creditors of the bankrupt, pro rata, as their interests might appear. The court held that the bank could not set off its obligation owing the bankrupt against that sum, inasmuch as to do so would be to permit the bank to act in violation of the express agreement pursuant to which the funds were deposited with it. Again, this is a clear case of an estoppel, and each of the requisite elements is present.

In the case of *Twentieth Street Bank v. Gilmore,* 71 F. 2d 594, cited at pages 20 and 21 of Appellee's brief, the deposit was made by a creditors' committee for the express purpose of accumulating a fund for the creditors. The president of the plaintiff bank was a member of the committee and knew of and participated in the formulation of the policies pursuant to which the committee was operating the bankrupt. The court held that these were not deposits in the ordinary course of business and that the bank, through its president, knew they were not. The court referred to the Loble case as one ". . . where the

deposits were the proceeds of a sale to raise funds for Eastern creditors, and it was held that the circumstances under which the funds deposited were raised and the co-operation of the bank with the depositor so far impressed them with a trust as to estop the bank from asserting its right of set-off". (71 F. 2d 597)

These are the only cases cited by Appellee in support of the proposition that, although none of the "technical" elements of estoppel, waiver, trust fund or special deposit are present, the bank should, nevertheless, be denied its right of set-off. In each of these cases, however, the "technical elements" of either waiver, estoppel, trust fund or special deposit were present. In none of these cases is the factual situation described analagous in any way to that presented in this case. In this case there is admittedly no agreement between the creditors; rather there is a conditional extension granted by the Bank to the Bankrupt. Further, the account was in all respects and at all times a general commerical account, and was in no wise or at any time a special account, nor did it have any of the characteristics of a special account, nor was there any restriction of any kind upon the right of the Bankrupt to check on it or any understanding of any kind, express or implied, that the account should be used for any particular purpose or limited in any way whatsoever.

APPELLEE'S PROPOSITION III

Appellee has devoted this Proposition to a discussion of the case of *Union Bank and Trust Company of Helena, Montana v. Lester H. Loble, Trustee,* 20 F. (2d) 124. Although this case was the subject of Proposition IV of Appellant' opening brief, we feel that Appellee has made some erroneous statements and drawn some erroneous conclusions that require comment.

On page 25 of his brief, Appellee contests a statement made in Appellant's opening brief to the effect that we did not feel the Honorable District Judge regarded the *Loble* case as requiring the denial of the right of set-off in this case. Appellee quotes a statement made by the Honorable District Judge in his Memorandum of Decision that "I do not feel that I should strain to distinguish the Loble case, and I will follow the view the Referee took of it." The whole Memorandum Decision is included in the Transcript of Record at page 27. However, in order that the statement quoted in Appellee's brief may be properly understood, we wish to here quote the paragraph preceding it. (Transcript of Record, p. 27)

> "Because I am not impressed as an original proposition that such a loose arrangement, as presented here, should work a loss of the Bank's right of set-off, I have examined Union Bank & Trust Co. vs. Loble, 20 F. 2d 124, closely. The learned Referee thought it was controlling; counsel for petitioner strongly urges that the present case and that case are distinguishable."

This indicates to us that the trial court was by no means convinced either that the Bank should be pre-

cluded from it right of set-off or that the *Loble* case so held. It is our humble opinion that the Court could hardly have said more without reversing the Referee and that the only reason that the trial court did not do so was because it felt that, since this Court decided the *Loble* case, this Court should do the distinguishing. And we submit that it is properly distinguishable.

Beginning at page 25 of his brief, the Appellee discusses the factual comparison made by Appellant in its opening brief of the Loble case with the case before this Court. The explanation is advanced that each factual difference does not, or should not, make any difference in the outcome of the case. Appellee missed the point of the comparison. We did not and do not contend that each comparative item in itself is a decisive distinguishing characteristic. The purpose of the outline was to compare *each* of the facts in the Loble case, as disclosed by the opinions of the District Court and this Court, with each comparable fact in this case. The outline was not limited to the distinguishing facts. The point and purposes of the outline, and it is clearly shown, is that in no material particular are the facts of this case similiar to the facts in the *Loble* case. Further, the particular facts regarded as decisive in the holding in the *Loble* case are directly opposed to comparable facts in this case.

In his discussion of comparative item No. 4 (at page 29 of Appellant's brief and page 28 of Appellee's brief) Appellee makes an erroneous statement of fact. The following statement is made:

> "In this case the purpose of the creation of the fund was clearly expressed, that is, to pay all creditors

> alike, 10% of the amount of their respective accounts monthly. The bank account was just as much earmarked for a particular purpose in the one case as in the other. In neither case was a special account created. In both cases the proceeds of the sale were deposited in the regular pre-existing general bank account of the bankrupt, and were subject to withdrawal upon the checks of the bankrupt alone." (Appellee's brief, page 29)

In this case the only evidence is, and the referee found, that the general commercial account maintained by the Bankrupt from 1946 was unchanged until it was closed the day after the petition in bankruptcy was filed. There was no fund and there was no special purpose. Insofar as the Bank was concerned there was no restriction of any kind on the Bankrupt's right to use the account for any purpose it saw fit, and it could have paid one creditor in full or drawn a check to some charity. Further, there was no "sale" as implied in the paragraph above quoted. The Bankrupt intended to and did continue to conduct its business in the usual way. (Transcript of Record, pp. 39, 40, 41)

In the *Loble* case, there was "an extraordinary sale of the bankrupt's stock" and it was agreed that "the proceeds of the sale would be deposited in the bank and devoted to the payment of urgent Eastern creditors . . ." (14 F. 2d 116) The sale was held and the proceeds deposited subject to this agreement.

Appellee's inference that a special sale was had and the proceeds "earmarked for a particular purpose" is in error. That was true in the *Loble* case, but it is not true here, and the factual difference is a very material one.

We also submit that the Appellee made another erroneous assertion at page 31 of his brief. On that page the following statement is made:

> "The bank in the Loble case made no more of a diversion of the funds in the bank account than did the Bank in the case at bar. In both cases the Bank endeavored to exercise a right of setoff in its own favor when the plan of operation, under which the bank account was created, was not carried out by the Bankrupt."

In the *Loble* case the specific agreement was that the special fund created by the special sale was to be used for the payment of particular creditors. There was a special contract as to the purpose for which the account might be used. In this case the use of Bankrupt's account was not in any way a part of the "understanding" between the Bank and the Bankrupt. In the *Loble* case there was a diversion of funds from the specific use for which the particular account was created. In this case the account was not created for any particular purpose, nor were any funds deposited in it for any particular purpose, nor was there any restriction of any kind on the Bankrupt's right to make such use of the account as it saw fit. The distinction is that in the *Loble* case the bank diverted the money in a manner contrary to the express agreement; in effect, it took the money deposited with it for safekeeping, as in the case of *Lyman v. Belfast National Bank,* 98 Me. 448, 57 At. 799, and used it in a manner not permitted by that agreement. In this case there was no agreement of any kind. The Bankrupt's account was in all respects and at all times a gen-

eral commercial account, and the Bank's exercise of the setoff was not inconsistent with what it had done before.

The Appellee, at page 31 of his brief, states that he is unable to see why it should make any difference that in the *Loble* case the setoff was exercised before bankruptcy, while in this case it was exercised after the petition in bankruptcy was filed. There is a reason, and a very cogent one, why the exercise of the right after the petition in bankruptcy was filed was in all respects proper. It will be remembered that the agreement between the Bankrupt and the Bank in this case was that the Bank would refrain from pressing the Bankrupt for payment in full of the balance owing it "providing the monthly payments of 10% were made." (Transcript of Record, p. 18, Finding of Fact paragraph 5). The filing of the petition in bankruptcy was an admission by the Bankrupt that it could not keep its part of the agreement; that is, that it could not make the 10% monthly payment as it had agreed. The Bank was therefore free to proceed to collect the full amount owing it. The only promise of the Bank, even as to setoff, was conditional. When the condition was breached, all rights, including setoff, were restored.

Appellee contends that it is "inequitable" to permit the Appellant Bank to make use of its set-off. If what Appellee means by "inequitable" is that the exercise of the right of set off by Appellant affords to it a greater percentage of its claim than that which will be received by other general creditors who were not indebted to the Bankrupt, and consequently do not

have such a right, this may be true. But it is suggested that, while the exercise of such a right may result in an "unequal" distribution, it is not "inequitable" any more than the unequal distribution which results from payment of a greater amount to a secured or preferred creditor. This right of setoff is one factor taken into consideration by a bank in making a loan to a depositor. And it is no different from the same right which is granted to every other creditor of the bankrupt who may buy from as well as sell to the bankrupt or in any other manner or for any other reason become indebted to the bankrupt. Quite obviously Congress does not consider this right inequitable because it has been expressly confirmed in Section 68a of the Bankruptcy Act.

The Bank had the right of setoff at the time the Bankrupt failed to make the June payment. When it filed its petition in bankruptcy, the Bankrupt stated to all the world that it could not pay its obligations and it was at that time, after the Bank had given the Bankrupt every opportunity to keep its agreement, that the Bank exercised its right of setoff. Certainly the Bank's actions were not inequitable. On the contrary, it would be grossly inequitable to deny the right of setoff under these circumstances.

One further observation. The statement is made at page 32 of the Appelle's brief that "there is no basis whatsoever for the statement that the Bank account in the *Loble* case was created (if by this is meant newly established or open) as a part of the agreement that was entered into." The account was not newly established

or opened as a result of the agreement. Appellee is correct in that statement, but the *credit balance in the account* was created as a direct result of the agreement. It was the same as if a new account had been opened. A credit was created where there had been a debit, and the credit was established with the express understanding that it was to be used for a strictly limited purpose, and that was in the payment of certain specific creditors. (14 F. 2d page 116, Appellant's Brief p. 26). The important point is not, as the Appellee has inferred, that the Bank did or did not act as a watchdog over the Bankrupt's use of the account; but rather that the Bank, having agreed that the account should be used for a specific purpose, could not thereafter appropriate it to some other purpose. That is precisely the interpretation of the *Loble* case that was pronounced by this Court in the case of *Ingram v. Bank of Cottage Grove* (1928), 29 F. 2d 86, discussed at page 32 of Appellant's brief. It is the same interpretation that has been given by every other court that has considered the *Loble* case.

CONCLUSION

In their conclusion counsel for Appellee state that they have at no time contended, as stated by us, that an extension of time to pay a delinquent obligation operates as an absolute waiver of the right to proceed with the collection of the obligation. In the next paragraph, Appellee asserts that "the uncontroverted finding of the Referee was that the Bank agreed to go along with the Plan and refrain from pressing for immediate payment in full of the indebtedness due, providing that the monthly payments of ten per cent were made," and that because of that agreement, Appellant cannot make use of its set off. We must admit to having some difficulty reconciling these two statements. It seems to us that the second statement is in direct contradiction to the first.

Appellee also stated that "the same condition attached to the obligation of every other creditor participating in the Plan." The extension granted by Appellant Bank had no connection with and was not conditioned upon an extension by the other creditors. The facts are that the Bankrupt went to the Appellant and requested an extension of time within which to pay its matured note; that Appellant granted this conditional extension in the hope that the Bank would be able to work out of its difficulty; that after obtaining this conditional extension from Appellant, the Bankrupt made similar requests of other creditors—acting separately in each instance—and obtained the consent of *some* of them to defer enforcement of their claims until the Bankrupt had an opportunity to try to reduce its in-

debtedness in the ordinary course of business with the hope and expectation, after having done so, of continuing in business; that there was no general plan and no agreement of any creditor to grant an extension of time or other indulgence in consideration of or in reliance upon the agreement of any other creditor; that there was no agreement whatsoever that the amount should be used for any purpose; that the Bankrupt failed in its efforts to accomplish this purpose and decided to file a petition in bankruptcy, and that, after the petition was filed and it was clear that the purpose could not be accomplished, Appellant exercised its legitimate right of set-off covering the balance in the commercial account.

If such action on the part of Appellant estops or precludes it from exercising its right of set-off, it necessarily follows that, under such a construction of the statute, the only possible alternative remaining for a banking institution, or any creditor having a potential set-off, is to refuse to cooperate with debtors in the solution of their financial problems and to exercise its right of set-off at the first opportunity, regardless of the consequence. This, we respectfully urge, is not and was never intended to be the law and certainly is not in the best interests of any of the parties.

Respectfully submitted,

V. V. Pendergrass,
R. R. Bullivant,
Walter H. Pendergrass,

Attorneys for Appellant.